Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers	)	CC Docket No. 00-256
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	)	CC Docket No. 98-77
	)	
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	)	CC Docket No. 98-166

COMMENTS OF AT&T CORP.

James P. Young
Christopher T. Shenk
Sidley Austin Brown & Wood LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Mark C. Rosenblum
Judy Sello
AT&T Corp.
Room 1135L2
295 North Maple Avenue
Basking Ridge, NJ 07920
Tel. (908) 221-8894
Fax (908) 221-4490

Attorneys for AT&T Corp.

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Pursuant to the Commission's Further Notice of Proposed Rulemaking ("*Notice*"), released November 8, 2001, and Section 1.415 of the Commission's rules, 47 C.F.R. § 1.415, AT&T Corp. ("AT&T") submits these comments on the establishment of an appropriate incentive regulation mechanism for rate-of-return carriers.

INTRODUCTION AND SUMMARY

The Commission properly rejected MAG's proposed incentive regulation plan, and now seeks comment on a more appropriate and balanced incentive regulation plan for rate-of-return local exchange carriers ("LECs") that adequately protects the interests of consumers. *See Notice* ¶¶ 217-20. As the Commission found, MAG's "revenue-per-line" approach is ill-conceived, and the MAG plan contained no productivity offset. *Id.* ¶¶ 218-20. The Commission should promptly adopt an incentive regulation plan, but only after correcting the fundamental shortcomings in MAG's incentive regulation proposal.

As explained in Section I, the Commission should adopt a plan that protects the interests of consumers and encourages rate-of-return LECs to operate efficiently. The MAG proposal, which would apply a revenue per line ("RPL") approach to all costs (including traffic sensitive costs), would be anticompetitive because it would allow rate-of-return carriers to offset losses to competitors by raising other rates. *See Notice* ¶ 231. Accordingly, the Commission should adopt the RPL approach for common line services only, and it should adopt conventional price caps for traffic sensitive and special access services. The Commission should also require a LEC to exit the NECA pool when it becomes subject to incentive regulation. And the Commission should adopt an X-factor of 10 percent, applicable to traffic sensitive and special access services, to permit consumers to share in the expected productivity gains that should occur under incentive regulation. A 10 percent X-Factor, applied only to traffic sensitive and special access services, would have a minimal impact on the LECs' revenues, and would slowly bring these LECs' traffic sensitive rates down to the CALLS level for rural LECs over the next seven to eight years.

As shown in Section II, the Commission should apply incentive regulation to all but the smallest LECs. Based on the experience of the smaller LECs that have operated profitably under price cap regulation, many rate-of-return LECs generally could obtain substantial efficiencies and increased profits under incentive regulation. Accordingly, participation in incentive regulation should be mandatory for all carriers that serve a number of lines above a certain threshold (*e.g.*, 50,000) at the holding company level. Similarly, the Commission should retain – and enforce – its "all-or-nothing" rules that require a LEC to operate all of its affiliates under the same scheme of regulation. As the Commission and the D.C. Circuit have both explained, allowing LECs to operate its affiliates under different regulatory regimes creates numerous perverse and anticompetitive incentives for those LECs, and that remains true today.

Finally, as shown in Section III, additional pricing flexibility for rate-of-return LECs would be grossly premature. Rate-of-return carriers are dominant carriers with market power, and therefore additional pricing flexibility would be anticompetitive, absent significant competitive entry. *See, e.g., Notice* ¶¶ 247, 250. The rate-of-return LECs, however, face no significant competition.

I. INCENTIVE REGULATION FOR RATE-OF-RETURN CARRIERS SHOULD CONTAIN APPROPRIATE PROTECTIONS FOR CONSUMERS.

The Commission correctly concludes in the *Notice* that MAG's proposed scheme of incentive regulation for rate-of-return LECs does not sufficiently protect consumers and thus cannot be adopted in its current form. *Notice* ¶¶ 217-20. In particular, the Commission expresses concern that the MAG plan contains no annual productivity offset, and that the plan would therefore permit rate-of-return carriers "to increase their revenues without any recognition of the productivity gains that historically have been realized by the telephone industry." *Notice* ¶ 218. The Commission also rightly notes that MAG's proposed "revenue-per-line" approach would be harmful to consumers and would provide incentives for inefficient investment. *Notice* ¶¶ 220, 231.

As explained below, MAG's proposed incentive regulation plan should be amended in the following ways: (1) the Commission should adopt the RPL approach only for common line services, and it should adopt conventional price caps for traffic sensitive and special access services; (2) a LEC should be required to leave the NECA pool when it becomes subject to incentive regulation; and (3) the Commission should apply an X-factor to traffic sensitive and special access services.

A. The Commission Should Adopt The RPL Approach For Common Line Services, But It Should Adopt Conventional Price Caps For Traffic Sensitive and Special Access Services.

While the Commission could adopt MAG's RPL approach for common line rates, the Commission should adopt a more traditional price cap system for traffic-sensitive and special access rates. *See Notice* ¶¶ 229-33. The RPL approach is an appropriate mechanism for recovery of non-traffic-sensitive common line costs, but it would be anticompetitive and send harmful economic signals to carriers with respect to traffic sensitive and special access costs.

As the Commission notes, under MAG's proposal "[I]ncentive-regulated carriers would be compensated based on [RPL], which would be established using embedded costs and then adjusted for inflation . . . on a going-forward basis." *Notice* ¶ 31. Each carrier would settle with the NECA pool based on its inflation-adjusted RPL, and as a result, a carrier's settlement amounts from NECA would no longer be linked to its costs. Such a system differs from price cap regulation, MAG argues, because revenue growth would be based on growth in lines, not minutes.

The RPL approach would be appropriate for common line rates. Common line costs are non-traffic sensitive, and vary as a function of the number of lines rather than the volume of traffic. A mechanism for capping common line rates on a revenue per line basis is therefore a reasonable method of cost recovery. Indeed, that is essentially what the Commission adopted for price cap carriers' common line rates in the CALLS plan, when it raised the caps on the SLC and phased out the other common line rate elements. The "average price cap CMT revenue per line" cap in the CALLS plan (*see* 47 C.F.R. § 61.45(c)), like the RPL approach, limits price cap carriers to a specified revenue per line for recovery of common line costs.[1] Tariff filing procedures for such a system have already been developed in connection with CALLS and could easily be adapted to an RPL mechanism for non-price cap LECs.

The Commission should therefore adopt the RPL approach for common line rates with no annual price cap adjustments (*i.e.*, GDPPI – X adjustments), as is currently done under CALLS.[2] Under this approach, SLC rates would generally remain constant over time once they reach their caps, while Interstate Common Line Support would remain fairly constant on a per-line basis.[3] On the other hand, if the RPL were adjusted annually for inflation while SLCs were capped, as proposed by MAG, ever increasing amounts of USF support would be required, with growth in USF significantly exceeding the growth in lines.

The RPL mechanism, however, should *not* be applied to traffic sensitive and special access rates. Indeed, MAG has never offered any justification for applying an RPL mechanism to traffic sensitive services, nor could it. *See* MAG Petition at 16-17. A guaranteed RPL would be inappropriate in an environment of emerging competition where some components of access, such as transport, may be provided by competitors. For example, if competitors provide transport services formerly provided by an incumbent LEC, the RPL mechanism would permit the LEC to offset revenues lost to competitors by raising other rates in order to obtain its requisite RPL. Similarly, a LEC could offer discounts on services subject to competition, and offset those discounts with rate increases on other services. An RPL mechanism would also

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[1] Such a mechanism would also be functionally equivalent to increasing the g factor in the Commission's previous price cap regime to a full g. *See Access Charge Reform, et al.*, CC Docket 96-262, *et al.*, Comments of AT&T Corp., p. 21 (filed October 29, 1999).

[2] In other words, as in CALLS, the X-factor implicitly would be set equal to GDPPI. The Commission could, however, permit exogenous cost adjustments for common line rates.

permit a rate-of-return carrier to offset losses where an access customer decides to provide its own transport or converts from switched access to special access. For these reasons, an RPL mechanism would be inconsistent with the pro-competitive goals of the Commission and should be rejected. *See Notice* ¶ 231 ("it appears that in some cases, as when competition exists, a carrier could lose lines and thus revenues, while under a pure revenue cap structure, it could increase prices to recover any shortfall").

The Commission should therefore adopt conventional price caps for traffic sensitive and special access services. *See Notice* ¶ 232. The Commission should cap traffic sensitive and special access rates directly, as is the case both in conventional price cap regulation and under CALLS, and it should also apply annual GDPPI-X adjustments to these services. The overall scheme would be similar to CALLS in some respects, with common line rates remaining constant and X-factor reductions directed toward the traffic sensitive and special access categories. Since productivity growth for these categories tends to exceed that for the common line category (as shown in the Appendix), such a scheme is consistent with economic efficiency. The RPL approach, if applied across the board to all access services, would create harmful economic incentives.

B. LECs Should Be Required To Leave The NECA Pool When They Become Subject To Incentive Regulation.

Under AT&T's proposal, a rate-of-return carrier would be required to leave the NECA pool when it becomes subject to incentive regulation. *See Notice* ¶ 228. Incentive regulation is fundamentally incompatible with pooling, both in theory and in practice, and therefore LECs subject to incentive regulation should not remain part of NECA.

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[3] The Commission could include a "hyper-inflation" provision like that in CALLS to deal with the possibility of inflation exceeding a certain threshold, in which case the RPL would be adjusted for inflation minus an X-factor.

Today, NECA's member carriers, through participation in the pool, spread the risk of fluctuations in costs. The Commission has recognized, however, that spreading the risk of cost fluctuations is fundamentally at odds with incentive regulation. Incentive regulation seeks to create incentives for carriers to minimize their costs, and mechanisms that spread the risk of fluctuations in costs are fundamentally incompatible with that objective. *See, e.g., Policy and Rules Concerning Rates for Dominant Carriers,* Second Report and Order, 5 FCC Rcd. 6786, 6819 (1990) ("*LEC Price Cap Order*") ("[p]articipation in pools, by its nature, entails risk-sharing, and thus a weakening of incentives to operate efficiently").[4] The Commission has thus recognized that incentive regulation would necessitate, at a minimum, fundamental changes to the nature of the NECA pools, and for that reason it has declined to require rate-of-return carriers to opt into the price cap system. *See Policy and Rules Concerning Rates for Dominant Carriers,* CC Docket 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd. 3195, ¶ 179 (1988) (price cap regulation for NECA pool carriers would "require fundamental alterations to the purposes, structure, and operation of the pools").

AT&T's proposed scheme of incentive regulation would require a LEC to leave the NECA pool at the time it becomes subject to incentive regulation. Price caps would be applied to the rates of individual LECs, not to pooled rates. Price cap LECs would set their own rates and obtain revenue from their own customers, not via settlements from the pool. Indeed, pooling would be inconsistent with the use of price caps not only as a theoretical matter but also as a practical matter. It is difficult to imagine how the Commission could determine the settlement

[4] MAG itself recognizes as much. *See Notice* ¶ 230 (MAG recognizes that its incentive regulation plan must break the link between prices and costs, to provide incentives to reduce costs).

rates that would be provided to price cap carriers in the context of a pooling arrangement.[5] To obtain the maximum public interest benefits from incentive regulation, the Commission should apply conventional price caps to traffic sensitive rates (as explained above) and prohibit such carriers from participating in any pooling arrangement.

C. The Commission Should Establish An X-Factor For Carriers Subject To Incentive Regulation.

Finally, the Commission should adopt a productivity offset targeted to traffic sensitive and special access services. As the Commission correctly concludes, "the inflation-adjusted RPL component of the MAG incentive plan would allow carriers to increase their revenues without any recognition of the productivity gains that historically have been realized by the telephone industry." *Notice* ¶ 218. As a result, the MAG plan would not produce "rates . . . [that are] just and reasonable, as required by section 201(b) of the Act." *Id.*; 47 U.S.C. § 201(b). For these reasons, the Commission properly rejected the MAG plan as currently constituted, because it would not "properly balance carrier and consumer interests." *Notice* ¶ 217. Under the MAG plan, "all of the benefits of productivity or efficiency improvements would accrue to the carrier in the form of higher returns, and none of the benefits [would] accrue to access customers." *Id.* ¶ 218. As the Commission notes, comparing the MAG plan with actual revenues from 1995-1999, AT&T has calculated that rate-of-return carriers would have realized $424 million more in revenues in 1999 under the MAG plan than they realized under rate-of-return regulation, due to productivity gains in switching and transport. *Id.* Therefore, the Commission should adopt an

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[5] In addition, LECs that utilize average schedules should not be allowed to utilize incentive regulation. As noted by ICORE in its response to the MAG access charge tariff filings (CCB/CPD 021-23), at 3, average schedule companies base their rates on industry rather than company specific information. Any incentive plan should be based on company specific information.

X-factor, to permit consumers to benefit from carriers' productivity and efficiency improvements.

Appendix A includes calculations of an imputed X-factor for the AT&T proposal, which consists of capping common line revenue per line at a constant amount and then applying traditional price caps with an X-factor to rates for traffic sensitive and special access services. Because the X-factor is not applied to the common line category, a higher X-factor is needed to produce revenue neutrality.[6] This is entirely appropriate, because productivity gains tend to be concentrated in switching and transport, rather than in common line services. Indeed, until 2000, the Commission's price cap regime did not recognize these differences in productivity gains and applied the X-factor evenly to all price cap baskets.[7] As a result, by 2000, "price cap LECs' basket earnings [were] significantly higher for traffic-sensitive services than for common line services." *See Access Charge Reform, et al.*, CC Docket Nos. 96-262 *et al.*, Sixth Report and Order, 15 FCC Rcd. 12962, ¶ 171 & n.376 (2000) ("*CALLS Order*") (in 1999 price cap LECs earned "rates of return of 85 percent for the traffic-sensitive basket, 20 percent for the trunking basket, and 15 percent for the common line basket"). The Commission addressed that problem in the *CALLS Order* by targeting X-factor reductions to traffic sensitive services. *See CALLS Order* ¶ 171. To avoid creating the same imbalances again, the Commission should apply the X-factor to switching and transport services when implementing incentive regulation for rate-of-return carriers.

Appendix A, Table 1 shows data on the common line pool, with various growth rates shown in the lower portion. NECA's common line revenue requirement grew at an annual rate of 6.64 percent from 1995 to 2000, which is only slightly more than the annual growth in access

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[6] Special access is not included in this analysis.

lines of 6.23 percent. Because the trend in revenue requirement per line was essentially flat, the data confirm that it would be reasonable to cap common line rates and USF support on a constant revenue per line basis.

Table 2 in Appendix A shows data on the traffic sensitive pool, with special access revenue removed. Various growth rates are shown in the lower portion, indicating that traffic sensitive revenue requirements declined gradually during the 1995-2000 period and traffic sensitive revenue requirements per minute declined by 8.3 percent per year. The proposed AT&T plan is simulated in Table 4. The plan permits common line revenue to grow at the same rate as lines growth, while conventional price caps are applied to other rates. With special access removed from the data on traffic sensitive revenue, an imputed X-factor of 9.63 percent is calculated for 1995-2000.[8] The Commission could then round the 9.63 percent X-factor up to 10 percent, to include a Consumer Productivity Dividend, as it did for the price cap carriers. *See LEC Price Cap Order*, 5 FCC Rcd. at 6798-99. As shown in Appendix B, the smaller price cap carriers have reduced their switched access rates far more than similarly sized rate-of-return carriers during the past five years; if anything, as this experience suggests, AT&T's proposed X-factor, even with the Consumer Productivity Dividend, would be generous to the rate-of-return LECs.

Indeed, these X-factors are not as high as they might seem at first glance, because these X-factors would not be applied to the common line category, which contains the lion's share of

[7] The one exception to this was the "Interexchange" basket, which had its own separate X-factor.
[8] AT&T could not include special access in these calculations because of a lack of data, although AT&T has used the partial data available to attempt a preliminary analysis. *See* Appendix A at 7-8 & Table 5.

the LECs' interstate revenue.[9] If the GDPPI increases at a 2 percent annual rate, a 10 percent X-factor will reduce traffic sensitive rates by about 8 percent each year, which would cause the average traffic sensitive rate per minute to decline from $0.0178 (the current level as of January 1, 2002) to around $0.0095 over a period of about seven to eight years.[10] This gradual transition would give the LECs ample time to reduce costs and bring their average traffic sensitive rates down to the same level as rural LECs under CALLS. Moreover, since traffic sensitive and special access rates account for only about 35 percent of the LECs' interstate revenue, these 8 percent annual reductions are equivalent to across the board reductions in all interstate rates of about 2.8 percent (35% times 8%). AT&T's proposal is thus more generous to the rate-of-return LECs than the Commission's recent price cap regime with a 6.5 percent across the board X-factor. Since demand is likely to grow by more than 2.8 percent annually, the LECs would probably continue to realize moderate growth in their interstate revenues even under AT&T's proposal.

Finally, to account for differences in the rate-of-return carriers, the Commission should consider offering carriers an option of two X-factors, 10 percent and 11 percent. As was the case with price cap carriers, however, the Commission would have to require sharing of earnings above a certain threshold for the lower of the two X-factor options. *See LEC Price Cap Order* ¶ 120; *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd. 8962, ¶¶ 210-22 (1995). There should be no lower formula adjustment ("LFA") unless the incentive plan also contains a provision for sharing earnings

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[9] According to AT&T's analysis of the December 17, 2001 MAG access charge tariff filings, nearly 65 percent of the rate-of-return LECs' interstate revenue is in the common line category, so that the 10 percent X-factor would be applied to only 35 percent of the LECs' revenue base.

above a certain level with ratepayers. If there is an LFA, it should be determined at the tariff filing entity level (as is done for LECs operating under price cap regulation), which could be at the holding company level rather than at the study area level as MAG proposes. Permitting LFAs below the filing entity level encourages LECs not to consolidate their study areas, which increases their ability to obtain such an adjustment and to qualify for greater (and unnecessary) support under the local switching support and high-cost loop support programs. Not only are the proposed 10.25% and 10.75% thresholds for a LFA overly generous because they are well above LECs' current cost of capital, but there is no reason why a LEC with fewer study areas should have a higher threshold.[11] As under the price cap plan, a single LFA threshold should apply for all carriers.[12]

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[10] The $0.0178 average traffic sensitive rate was calculated from the December 17, 2001 MAG access charge tariff filings. Annual reductions of 8 percent would reduce this figure from $0.0178 to $0.009930 over seven years and to $0.009135 over eight years.

[11] As AT&T has previously shown, the LECs' cost of capital in 1999 was between 8 percent and 9 percent, and the authorized rate-of-return should have been prescribed at the midpoint of that range. *See* Responsive Submission of AT&T Corp. to Prescription Proceeding Direct Case Submissions and Reply Comments on the Notice of Proposed Rulemaking, *Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 98-166, 28-31 (filed March 16, 1999). Given the sharp decline of interest rates since then, LECs' current cost of capital is probably much lower.

[12] Although the Commission should *not* adopt the MAG incentive regulation plan, AT&T has also included in Appendix A an updated version of the analysis of the MAG plan that it submitted last year. *See* Comments of AT&T Corp., pp. 15-17 (Feb. 26, 2001). Based on this analysis, the X-Factor under the MAG plan should be no less than 4.7 percent. *See* Appendix A at 2-5.

II. THE COMMISSION SHOULD REQUIRE LARGER RATE-OF-RETURN LECS TO OPT INTO INCENTIVE REGULATION, AND IT SHOULD ENFORCE THE "ALL-OR-NOTHING" RULE.

A. Incentive Regulation Should Be Mandatory For Larger Rate-of-Return LECs, And Optional For All Other LECs.

The Commission should make incentive regulation mandatory for larger rate-of-return LECs. *See Notice* ¶¶ 266-271. The purpose of incentive regulation is to "foster competition and efficient pricing in the market for interstate access service, and to create universal service mechanisms that will be secure in an increasingly competitive environment." *Notice* ¶ 3. The larger rate-of-return LECs (*e.g.*, those with at least 50,000 lines) have the scale to benefit from the efficiency incentives inherent in price caps. Indeed, optional participation would undermine the Commission's goals. LECs would have an incentive to opt into incentive regulation only when their costs are at a cyclical peak, and they would also have an incentive to engage in inefficient "gold-plating" of their networks prior to opt-in, in order to ensure maximum possible revenue requirements under the incentive regulation plan. *See also LEC Price Cap Order* ¶ 335 n.450. These activities clearly would deprive access customers, as well as end-user customers, of the full spectrum of efficiencies that incentive regulation aims to achieve. For these reasons, participation in incentive regulation, as a general rule, should be mandatory.[13]

[13] The case for mandatory participation is further buttressed by the fact that numerous carriers that operate under *inter*state rate-of-return regulation successfully operate under state incentive regulatory regimes for the provision of *intra*state access services. For example, according to ALLTEL Form 10-K for the year ended December 31, 2000, at 11, it has elected such intrastate regulation for its subsidiaries operating in the states of Alabama, Arkansas, Florida, Georgia, Kentucky, North Carolina and Texas. Similarly, TDS explains in its Form 10-K, for the year ended December 31, 2000, at 30, that its subsidiaries in Alabama, Arkansas, Georgia, Michigan, Minnesota and Pennsylvania operated under price cap regulation during the year 2000. TDS expected to operate additional subsidiaries under an alternative regulatory plan in the states of Florida and Wisconsin during 2001. Roseville Telephone Company also operates under an incentive regulation plan in California. California Public Utility Commission, Decision 96-120-74.

As the Commission points out, however, there are wide variations in operating conditions among rate-of-return LECs, and certain rate-of-return LECs may not thrive under incentive regulation. *See Notice* ¶ 227. Empirical evidence, however, demonstrates that the Commission's concerns are, at best, limited to those carriers that serve a small number of lines. According to AT&T's analysis, smaller price cap carriers have generally earned rates of return far in excess of 11.25 percent – the authorized rate of return for carriers under rate-of-return regulation. *See* Appendix B. For example, Frontier Tier 2 Companies earned 38.95 percent in 2000 and serve approximately 272,400 lines. In fact, even very small price cap LECs have thrived under price cap regulation. The Citizens Telecommunications Company (Tariff 3) earned 16.12 percent in 2000 and serves only 23,000 lines. *See id.*[14] There is no reason why similarly sized carriers operating under the MAG plan would not enjoy similar success. Thus, voluntary participation in incentive regulation should be limited to those LECs that serve fewer than a specified threshold of lines (*e.g.*, 50,000) at the holding company level.

To the extent that a smaller LEC chooses to opt into incentive regulation, that decision should be permanent. Allowing LECs to move in and out of incentive regulation would substantially undermine the incentive to succeed within the incentive regulation environment. Instead, LECs would have an incentive to "try out" incentive regulation to determine whether higher profits could easily be achieved, and in cases where increased profits are not easily achieved, LECs would have the incentive to return to rate-of-return regulation. In addition, allowing LECs to move in and out of incentive regulation would allow them to "game" the

[14] Although GTE South Inc. (Virginia) is part of a larger holding company, its results are consistent with the overall results reported by all of GTE's operating entities. GTE South-Virginia serves only 36,500 lines and earned a rate of return of 24.74 percent in 1999 and 40.96 percent in 2000. The Interstate Rate of Return Summary, Final Reports (filed April 2, 2000)

system. *See, e.g., ALLTEL Corporation; Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control,* Memorandum Opinion and Order, 14 FCC Rcd 14191, ¶ 18 (1999) ("*ALLTEL Waiver Order*"). This Commission has already recognized that under an optional system, LECs have incentives to "fatten up" – *i.e.,* increase costs – before opting-in to incentive regulation where it could then "slim down" – *i.e.,* decrease costs – to maximize profits under incentive regulation. *See id.; see also NRTA* v. *FCC,* 988 F.2d 174, 179 (D.C. Cir. 1993) ("permanent-choice [rules] aimed at preserving cost incentives . . . are central to price cap [*i.e.,* incentive] regulation"). That behavior "would not serve the public interest." *Id.* Accordingly, to provide maximum incentives for LECs to succeed under incentive regulation, a decision to opt-in to incentive regulation should be, as a general rule, permanent.

There is an increasingly urgent need for mandatory participation in incentive regulation for the larger rate-of-return LECs (and a permanent opt-in rule for smaller LECs). Properly designed incentive regulation, which includes protections for consumers as discussed above, could provide hundreds of millions of dollars in consumer benefits annually. *See Notice* ¶ 218. Serious reform is now long overdue, and should be implemented promptly.

B. The Commission Should Retain – And Enforce – The "All Or Nothing" Rule.

The Commission should also reject MAG's proposal to eliminate the all-or-nothing rule. *See Notice* ¶ 263. In 1993, the D.C. Circuit explained that "it seems quite obvious that dual regulation . . . has a key feature in common with regulated-unregulated dual status: a firm can escape the burden of costs incurred in its unregulated *or* price cap business by shifting them to the rate-of-return affiliate, which can pass them on to ratepayers." *See NRTA,* 988 F.2d at 179-180. The Court went on to affirm the Commission's "all-or-nothing" rule, which was designed

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notes that GTE, when summed to the holding company level, achieved an overall rate of return to guard against such anticompetitive behavior by prohibiting LECs from owning facilities that are not subject to the same type of rate regulation. *See id.* at 181. Those rules are at least as essential today for protecting the public interest as they were when first adopted in 1990. *See LEC Price Cap Order*, ¶¶ 271-278.

LECs continue to have substantial incentives to engage in price-inflating cost-shifting between incentive regulation affiliates and rate-of-return affiliates. By shifting costs from price cap affiliates to rate-of-return affiliates, LECs can – as they could when the Commission first adopted its all-or-nothing rule – increase profit margins for incentive regulation affiliates, while continuing to receive the same return for rate-of-return affiliates. In addition, LECs would have incentives to "game" the system through sequential mergers and acquisitions. *See, e.g., NRTA*, 988 F.2d at 179 ("successive mergers or acquisitions [that] enabled a firm to shift back and forth between rate-of-return and price cap [would create] . . . a risk of . . . sequential cost shifting"). These competitive concerns are only enhanced by changes in the telecommunications business since 1990. With potential competition, LECs now have additional incentives to lower costs through cost-shifting strategies in order to foreclose competitive entry. For example, a LEC that obtains artificially high profits through a cost-shifting strategy could use those excess profits to subsidize its retail services in a study area where competitors have entered, thereby implementing a price squeeze against those new entrants.

The competitive concerns associated with eliminating the all-or-nothing rule are not speculative. As explained by this Commission when it first adopted the all-or-nothing rule, "the record in this proceeding, like the records developed in other proceedings before the Commission, demonstrates that LEC holding companies have both the means and the motive to

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of 22.89 percent.

shift costs improperly from affiliates under one regulatory system to affiliates under another system, to the detriment of ratepayers." *LEC Price Cap Order* ¶ 272. LECs continue to have substantial incentives to engage in improper cost shifting and continue to have the means to implement such strategies. And given the size and complex ownership structures of today's LECs, it would be virtually impossible to detect this type of anticompetitive behavior without additional (and cumbersome) accounting guidelines that would allow the Commission and interested parties to monitor LEC accounts for cost-shifting.

In this regard, it is important to note that the Commission's jurisdictional accounting regulations clearly are insufficient to monitor and protect against the unlawful cost-shifting and gaming strategies that dual regulation LECs would be motivated to implement. When the Commission previously addressed this same issue in 1990, it explained that "[w]hile state regulation may be adequate to detect and prevent improper inter-affiliate and intra-affiliate cost shifts from the interstate category to the intrastate category, it is neither designed nor able to detect such cost shifts within the interstate jurisdiction." *Id.* ¶ 274. The D.C. Circuit agreed with that assessment, noting that such jurisdictional separation rules are "of little relevance for cost shifting entirely within the federal domain." *See NRTA*, 988 F.2d at 180. In addition, the Commission has noted that it did "not wish to create new administrative burdens for the Commission associated with monitoring affiliate transactions and taking appropriate enforcement action if necessary." *See ALLTEL Waiver Order* ¶ 38. And in any event, "[s]tructural separation does not cure the incentive to shift costs; it only makes cost shifting [more] detectable." *Id.* Thus, any claims that existing or new accounting separation rules could be used (or adopted) to avoid anticompetitive behavior by LECs that operate under dual regulation should be rejected.

As noted in the *Notice* (at ¶ 268), some parties favor abolishing the all-or-nothing rule on the grounds that the rule limits a carrier's ability to choose between the most appropriate form of regulation. That argument makes no sense. As explained on numerous occasions by this Commission and the D.C. Circuit, incentive regulation is superior to rate-of-return regulation for ensuring efficient provision of access services. *See, e.g., LEC Price Cap Order*, ¶¶ 271-279 (1990); *NRTA*, 988 F.2d at 178-181. The only circumstances where incentive regulation would not be "appropriate" are those where a LEC could not obtain sufficient cost savings under incentive regulation to make continued operations sufficiently profitable. But empirical evidence shows that this situation will arise, if ever, only very infrequently. An analysis of a representative sample of carriers illustrates that fact. From 1996 through 2001 a representative sample of small price cap (*i.e.*, incentive regulation) carriers have reduced switched access rates dramatically (many by more than 60 percent). *See* Appendix B. By contrast, even the largest carriers that currently operate under rate-of-return regulation have decreased access rates by only 8% to 16%, *see id.,* indicating that there is substantial room for additional savings on the part of rate-of-return LECs. There is thus no merit to LEC claims that the Commission's all-or-nothing rule deters them from choosing the "appropriate" form of regulation.[15] In all events, in the few instances where incentive regulation would contravene the public interest, the Commission may approve a waiver of the all-or-nothing rule.

Lastly, LEC claims that past approval of waiver applications suggests that the Commission's all-or-nothing rule is obsolete are specious. *See Notice* ¶ 270. Indeed, rather than

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[15] Similarly, LEC claims that the all-or-nothing rule prohibits cost-saving mergers are also baseless. As described above, there are substantial opportunities for cost savings and increased profitability in mergers between rate-of-return and incentive regulation carriers. Moreover, in the context of large mergers, a LEC holding company's risks are reduced because they can be spread out over all of the LEC holding companies' affiliates.

repealing the rule, the Commission should fully enforce it. The Commission's waivers in the context of mergers have allowed numerous rate-of-return carriers to remain under rate-of-return regulation, which has undoubtedly cost consumers millions of dollars in lost access charge reductions. These larger rate-of-return LECs that have been parties to these mergers are of sufficient scale to respond effectively to incentive regulation, and it is no longer in the public interest to shelter these LECs from full application of the all-or-nothing rule. The Commission should promptly apply incentive regulation to larger rate-of-return LECs, and it should not shield LECs from the all-or-nothing rule in future mergers.

III. THE COMMISSION SHOULD NOT ADOPT ADDITIONAL PRICING FLEXIBILITY RULES FOR RATE-OF-RETURN CARRIERS AT THIS TIME.

The Commission also seeks comment on the possibility of permitting rate-of-return carriers to obtain additional pricing flexibility. *Notice* ¶¶ 251-53. While such pricing flexibility would be clearly premature at this time, AT&T does propose some guidelines for essential prerequisites for such flexibility.

Rate-of-return carriers already have substantial pricing flexibility that is fully sufficient. As the Commission notes, rate-of-return carriers are already permitted to deaverage transport and special access rates in a study area if there is a single cross-connect in that study area, and they may offer volume and term discounts on transport services if a minimum threshold of DS1s are provided in central offices in a study area. *Notice* ¶ 246. Moreover, in the *Notice*, the Commission amended its rules to permit rate-of-return carriers to geographically deaverage their SLC rates, and the Commission also dramatically streamlined the requirements for introducing new services. *See Notice* ¶¶ 57-60, 199-205.

Any additional pricing flexibility would be grossly premature. As the Commission notes, rate-of-return carriers are dominant carriers with market power, and therefore additional pricing flexibility would be anticompetitive unless there has been significant competitive entry. *See, e.g., Notice* ¶¶ 247, 250. There has been virtually no competitive entry, however, in the rate-of-return LECs' territories. *See, e.g., Communications Daily*, p. 11 (November 14, 2001) (new Yankee Group study shows that rural LECs face little competition).[16] If anything, it is the CLEC industry that has collapsed. Absent competitive entry, pricing flexibility can be "used to erect a barrier to competitive entry." *Notice* ¶ 250. In particular, rate-of-return LECs could deaverage their rates, either on a geographic basis or through contract tariffs, to target attractive customers through lower rates or lengthy term contracts, and the LECs could fund such tactics by raising rates excessively to other customers. *Id.* For the foreseeable future, pricing flexibility would "inhibit competitive entry and deny customers . . . the benefits of competition." *Id.*

Indeed, the Commission's experience with pricing flexibility for price cap carriers has demonstrated some of the pitfalls of introducing pricing flexibility "too soon." *Id.* ¶ 250. Since mid-2000, Verizon, SBC, BellSouth, and Sprint and others have taken advantage of the Commission's generously lenient "triggers" and have obtained Phase II pricing flexibility for transport and special access services representing over $2.5 billion in annual revenues. Under Phase II, all formal rate regulation, including price caps, is eliminated, and the LECs are regulated essentially as nondominant carriers (with the exception that the price cap LECs continue to receive the benefits of the tariff filing requirement, such as the filed rate doctrine). The financial results of Phase II pricing flexibility so far are that (1) IXCs have not received X-

[16] The study shows that "lack of competition allows rural ILECs to control the 'customer relationship for most telecom products and services,'" and that when "the local phone monopoly segment of overall business was broken out, operating margins were 33% -- very high for telecom service provider[s]." *Communications Daily*, p. 11 (November 14, 2001). The "[m]argins for all services and products sold by rural ILECs were 16%." *Id.*

factor reductions amounting to over $100 million[17] that would have been received had those $2.5 billion in revenues remained under price caps, and (2) on top of that, some LECs have further *increased* the prices for those services that have received Phase II pricing flexibility.[18]

This pricing behavior is starkly inconsistent with the notion that competitive LECs' minimal investment in facilities in the relevant MSAs is placing any competitive pressure on incumbent LEC rates. *See Access Charge Reform, et al.*, CC Docket Nos. 96-262 et al., Fifth Report and Order, 14 FCC Rcd. 14221, ¶ 141 (1999) ("*Pricing Flexibility Order*") (Phase II triggers designed to detect "significant market presence" sufficient to preclude incumbent from exploiting its monopoly power). Indeed, these facts demonstrate that the Commission's existing *Pricing Flexibility Order* is a failure. Essentially, in those MSAs where LECs have been granted Phase II pricing flexibility, prices have either increased or are being maintained at the same level as when the carrier received Phase II pricing flexibility. Clearly, there is no competitive pressure for LECs to reduce prices nor is there is an incentive for LECs to negotiate contracts with IXCs to reduce prices.

In addition, pricing flexibility would be fundamentally inconsistent with any sort of revenue guarantee or pooling of any kind (*i.e.*, even the limited forms of pooling contemplated by the MAG plan). Under price cap regulation, the Commission has rules in place that generally prevent LECs from offsetting discounted rates with rate increases for other services. Discount offerings are usually treated either as new services or are removed from price caps entirely. Both

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[17] *See* Appendix C.

[18] BellSouth filed Transmittal No. 608, effective November 1, 2001, increasing Special Access rates for DS3 and DS1 services in MSAs with Phase II pricing flexibility. The filing resulted in an annual rate increase to AT&T of over $25 million. In addition, Verizon filed Transmittal No. 134, effective January 5, 2002, increasing Special Access rates for DS1 services in MSAs with Phase II pricing flexibility. The filing resulted in an annual rate increase to AT&T of over $24 million.

of these mechanisms prevent LECs from obtaining "headroom" under price caps that could be used to increase other rates when discounts are offered. Such mechanisms, however, are fundamentally incompatible with an RPL mechanism, which would permit LECs to offset any reduction in revenue from one service with higher rates on other services, so as to obtain the requisite amount of revenue per line. At a minimum, the Commission should require a LEC to leave NECA before it can obtain pricing flexibility.

Pricing flexibility "triggers" applied to rate-of-return carriers would also be administratively burdensome for both the Commission and other parties. Designing a pricing flexibility system that would accommodate the various characteristics of the rate-of-return LECs would be a momentous task. The existing pricing flexibility rules, based on levels of competition within an MSA, would be inappropriate for the smaller rate-of-return LECs, who have a very small presence in the majority of MSAs. Even the larger rate-of-return LECs are overshadowed by the larger price cap LECs in those MSAs where they operate together. Creating a pricing flexibility regime to fit rate-of-return LECs of many different sizes would result in a huge administrative burden for the Commission. In addition, the verification of the rate-of-return LECs filings to comply with such a system would be equally burdensome for the IXCs.[19]

For all of these reasons, any additional pricing flexibility for rate-of-return LECs would be premature at this time, as would be the establishment of "triggers" for any such flexibility.

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[19] Since the Commission has issued its *Pricing Flexibility Order* for price cap carriers, AT&T has had to review 16 pricing flexibility requests from 10 different price cap companies. These requests require AT&T and other CLECs to do an extensive amount of analysis and verification to insure that the facts and figures included in these voluminous waiver requests are correct. If rate-of-return carriers are permitted to apply for, and eventually be granted, pricing flexibility, AT&T and other IXCs will be required to devote substantial resources to analyze and verify these companies pricing flexibility requests for potentially over 1400 LECs.

See, e.g., Notice ¶ 255. If the Commission does adopt rules that would permit rate-of-return LECs to obtain pricing flexibility upon satisfaction of certain "triggers," however, it should adopt triggers that are more robust and reliable indicators of competition than has been the case for price cap carriers. Although AT&T does not propose a specific test here, the Commission should not permit any LEC to obtain additional pricing flexibility until, at a minimum, (1) the CCL charge has been eliminated for that LEC; (2) unbundled loops are available throughout the relevant area; (3) there are actual competitors in the area, as evidenced by the existence of competing LECs with status as "eligible telecommunications carriers" under Section 214(e) (47 U.S.C. § 214(e)), and (4) there are other reliable indicators of the existence of competitive facilities. The adoption of any such tests are premature, however, and the Commission can seek comment on such rules at a later time.[20]

[20] The Commission also seeks comment on the role of the Long Term Support ("LTS") mechanism under an incentive regulation plan. *Notice* ¶ 273. As the Commission points out, the purpose of the LTS mechanism was to prevent common carrier line ("CCL") rates of carriers that participated in the NECA common line pool from rising significantly above the national average CCL rates. *See Notice* ¶ 273; *see also Federal-State Joint Board on Universal Service,* Report and Order, 12 FCC Rcd 8776, ¶¶ 756-759 (1997). Given that the Commission has created a new universal service support mechanism – Interstate Common Line Support – to "replace the implicit support for universal service now recovered by rate-of-return carriers through the CCL charge" (*Notice*, ¶ 128), the LTS mechanism no longer serves any useful purpose. Accordingly, it would be appropriate for the Commission to merge the LTS support mechanism with the new Interstate Common Line Support mechanism.

CONCLUSION

For the foregoing reasons, the Commission should adopt an incentive regulation plan for rate-of-return carriers with appropriate consumer protections.

Respectfully submitted,

/s/ Judy Sello

Mark C. Rosenblum
Judy Sello
AT&T Corp.
Room 1135L2
295 North Maple Avenue
Basking Ridge, New Jersey 07920
Tel. (908) 221-8984
Fax (908) 221-4490

James P. Young
Christopher T. Shenk
Sidley Austin Brown & Wood LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Attorneys for AT&T Corp.

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